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USTR FOR EISSENSTAT, BHARMAN AND MCARRILLO
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SUBJECT: ASSISTANT USTR EISSENSTAT'S VISIT TO PERU - SCENESETTER

Sensitive But Unclassified, please handle accordingly.

11. (SBU) I welcome your August 30-September 1 visit to Peru to discuss the U.S.-Peru Trade Promotion Agreement (PTPA) with the Peruvian government, the local American and Peruvian business communities and members of civil society. The agreement is an important element of newly-elected President Alan Garcia's foreign and domestic policy priorities, and the government and the private sector are eager to secure passage by the U.S. Congress. The new administration took office on July 28, and has pursued an active agenda which focuses on both commercial and political outreach to important partners and a desire to spread more evenly the benefits of Peru's impressive economic growth over past years. These efforts include a plan for bringing commerce to the highlands ("Sierra Exportadora"), an expansion of Peru's trade agreement with Chile, interest in a trade agreement with Mexico, greater participation in APEC, and a vision to bring more small businesses into the formal economy so that they can also benefit from free trade. President Garcia has named renowned development economist Hernando de Soto to both implement the more participatory vision of free trade and to lead the GOP's effort to obtain passage by the U.S. Congress of the PTPA. Garcia, who speaks French but not English, is anxious to achieve early, positive results in order to help his APRA party fare well in the November regional and local elections. Despite a strong economy, Peru suffers from a weak and fractured political system. Continued U.S. engagement will be critical to the Garcia government's efforts to overcome political, economic and social challenges.

Free Trade to Reduce Poverty

12. (U) President Garcia is committed to further trade liberalization and has prioritized passage of the PTPA by the U.S. Congress, expanding trade ties with Chile, and increasing commercial links with Asia. In addition to naming university rector Felipe Ortiz de Zevallos as Peru's new Ambassador to Washington, Garcia asked renowned economist Hernando de Soto to be his personal representative for the PTPA. De Soto will spend most of September in Washington promoting PTPA passage. De Soto will also advise the GOP on reforms necessary to bring more Peruvians into the formal economy, thereby expanding the number of Peruvians that are able to access the opportunities created by the PTPA.

¶3. (U) For both economic and political reasons, the GOP seeks to strengthen its ties with neighboring South American countries. Peru and Chile signed an expansion of their 1998 Economic Complementation Agreement on August 22, 2006. The GOP also shares the Chilean government's desire to deepen trade between the Andean countries and Asia, and Peru will host the APEC ministerial and summit in 2008. Now that Peru has concluded a trade agreement with Chile, the Trade Ministry's negotiators are focusing on a deal with Mexico.

Strong Economic Growth and Macroeconomic Achievements

¶4. (U) The Garcia Administration has inherited one of the strongest economies in Latin America, and the country is entering its 19th quarter of sustained economic growth. The current expansion began in 2001, following the political crisis that ended the Fujimori Administration, and has gained momentum over the last several years.

GDP growth in 2005, at 6.7 percent, was the fastest since 1997. The economic expansion has continued into this year, despite the uncertainty created by the presidential elections. Analysts recently began raising their estimates for growth in 2006 from 5 percent to 5.5-6 percent. The 12-month average growth ending in May was 6.5 percent.

¶5. (U) The strong growth has been propelled by increased private investment, an export boom (triggered initially by the Andean Drug Eradication and Trade Promotion Act (ATPDEA) and aided later by high mineral prices), prudent fiscal management, and, more recently, strong domestic consumption and construction. Exports will have tripled by the end of this year compared to when President Toledo took office, rising from \$7 billion in 2001 to an estimated \$21 billion. Minerals make up just over half the exports, but non-traditional goods like textiles, apparel and agricultural products have grown significantly.

¶6. (U) The sustained economic expansion and, in particular, the agricultural export boom, have led to a moderate but significant reduction in poverty. The poverty rate - those living on less than \$2 per day - declined from 54 percent in 2001 to an estimated 48 percent today. Extreme poverty - those living on less than \$1 per day - declined more dramatically, from 24 percent to 18 percent, a 25 percent drop in four years. The areas that have seen the greatest reductions in poverty have been those participating in the agricultural export boom, (such as Ica where companies are reporting a labor shortage), and those that have been areas of focus for USAID programs. Analysts expect unemployment, underemployment and poverty to decline at a faster pace in the near-to-mid term as the expansion continues.

¶7. (U) Inflation has been tame despite the economic expansion, 1.5 percent in 2005 and an annualized rate of 2.5 percent in May 2006. The Toledo Administration lowered the debt-to-GDP ratio from 50 percent to 38 percent. The federal government will likely have a small surplus in 2006, due to fiscal restraint, greater tax revenues generated by the economic expansion and increased efficiency in tax collection.

Despite Past Record, the Country Is Optimistic

¶8. (SBU) When Garcia was last elected President in 1985 at the age of 35, the government was weak, the terrorist war with the Shining Path was spreading, inflation was rampant, and the international debt burden was very high. Garcia's policy decisions made matters worse - he restricted international debt payments to 10 percent of exports earnings, attempted to nationalize Peruvian banks and insurance companies and launched large public works projects without adequate financing. By the end of his term, inflation had gone from 87 percent to 7,649 percent, per capita income had dropped to below the 1960 level, the GDP had fallen 20 percent, poverty had grown from 41 percent to 55 percent, and the Shining Path was staging attacks in the capital.

¶9. (SBU) Despite this record, the business community and the population as a whole continue to express cautious confidence in Garcia's ability to manage the country and the economy during this second presidency. The President and his ministers understand that this confidence is tenuous, and some skeptics are concerned about

Garcia's reliance on populist gestures. He has sent some reassuring signals to the business community that he will respect contracts, show macroeconomic discipline, and welcome public-private partnerships for infrastructure needs. His center-left APRA party has intentionally tried to cast a wide net to bring in people from the center and center-right. Amongst Garcia's challenges as President will be keeping this informal coalition intact.

¶10. (U) Garcia's near term priorities include promoting agricultural modernization in the Andes through his "Sierra Exportadora" program and improving water quality and delivery. These programs were launched shortly after the inauguration, and if seen as credible, will help APRA leaders in the upcoming November regional and municipal elections. In the medium term, Garcia is looking to maintain macroeconomic growth while encouraging new investment.

Early Challenges

¶11. (SBU) The recent election results (52.6 percent for Garcia and 47.4 percent for leftist/nationalist Ollanta Humala) show a clear fracturing of the vote between those areas that benefit from international commerce and those that have thus far been excluded from national and global markets. In the coming months, President Alan Garcia will face greater pressure to strike a careful balance: to reassure foreign investors that his policies can sustain the current macroeconomic boom and improve Peru's investment climate, while winning over the pro-Humala opposition with tangible results of his poverty reduction policies. Specifically:

-- Garcia must implement a credible program to attack the high levels of poverty.

-- Given that the Peru Trade Promotion Agreement (PTPA) has not been approved by the U.S. Congress, Garcia must assume full responsibility for ratification of an agreement negotiated by the outgoing government. The President has tried to suggest that he could have gotten a better deal, but he realizes that PTPA is central to many of his proposed economic programs (e.g., "Sierra Exportadora").

-- The naming of renowned development economist Hernando de Soto, well-known in Washington and other capitals, is a sign that Garcia is committed to engaging pragmatically with the U.S. Congress. But is it also a sign that he is serious about expanding the "domestic FTA" agenda, i.e. expanding trade and export possibilities for a broader cross-section of the Peruvian economy.

Issues That the GOP or Press May Raise

¶12. (SBU) Your GOP and press interlocutors may raise with you:

-- President Garcia's appreciation for President Bush's invitation to visit the White House on October 10, and topics for that visit.

-- The GOP's urgent focus on poverty and the desire for 1) increased U.S. assistance in linking sierra and jungle producers to international markets, and 2) increased assistance for priority initiatives like clean drinking water programs.

-- The role that the U.S. can play in helping build and maintain investor confidence in the economy and in the Garcia administration.

-- The need for a contingency plan if the U.S. Congress does not pass PTPA by year's end. The GOP and the business community want to avoid a spike in U.S. tariffs if ATPDEA preferences expire before the PTPA enters into force, and will likely ask for an extension of ATPDEA to cover any gap. Papers have already begun to note the drop off in the growth rate of textile exports to the US, ascribing this slow-down to uncertainty among US importers of ATPDEA renewal. A key exporters association has the GOP propose a USD 100 million fund that would assist exporters and cover the costs of a temporary tariff spike. Reportedly, Peruvian exporters have had to sign contracts guaranteeing that they would pay US duties if these were to be levied starting in January 2007.

-- Peruvian media have also noted that Vietnam seems to have "moved up the list" in terms of US Congressional consideration of trade bills. There may well be questions concerning the priority the USG places on the PTPA, and why other trade arrangements (e.g. Colombia) seem to be moving through the ratification process faster than Peru.

Important Messages to Deliver

¶13. (SBU) Your visit at this time is crucial to both reminding the Garcia Administration of its commitment to the agreement and encouraging the government to make a critical effort on implementation. You and your team will also be able to consult and advise the private sector groups that are engaging with their U.S. counterparts and directly with Congress. We believe you should:

-- Remind the GOP that implementation is a key process that should be the focus of their activities;

-- Remind the GOP that the labor commitments are essential to passage of the PTPA in the U.S. Congress; and

-- Encourage the GOP to speak with one voice on the PTPA, and to coordinate, to the extent possible, its message in the U.S. with the private sector.

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